NO. 22434

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

CHARLES JOHN BARKHORN, JR.,	)	
	)	
Appellant,	)	APPEAL FROM THE UNITED
	)	STATES DISTRICT COURT
vs.	)	FOR THE DISTRICT OF
	)	HAWAII
ADLIB ASSOCIATES, INC., a Nevada corporation,	)	
	)	
Appellee.	)	
	)	

BRIEF ON BEHALF OF APPELLANT
CHARLES JOHN BARKHORN, JR.

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JURISDICTIONAL STATEMENT

The jurisdiction of the District Court was based upon 28 United States Code, Section 1331. The jurisdiction of this Court is founded on 28 United States Code, Sections 1291 and 1294.

Appellee's motion to dismiss complaint (Record 16-18) for lack of diversity because its principal place of business was in Hawaii (Record 16-26) was withdrawn and appellee ordered to file a responsive pleading (Record 48-49).

Judgment for appellee was entered December 11,

1963 (Record 206-207) and amended January 7, 1964 (Record 225). Notice of appeal from the judgment as amended was filed January 10, 1964 (Record 226-227). This court remanded for a determination of the issue of diversity jurisdiction (345 F. 2d 173 [1965]). The court below determined that it had jurisdiction to enter its original decision and entered judgment for appellee on October 17, 1967 (Record 256-257). Notice of appeal from the judgment was filed October 23, 1967 (Record 258-259).

STATEMENT OF THE CASE

On July 1, 1959, appellee, Adlib Associates, Inc., leased certain lands at Waikiki to Surf Associates, Inc. for 61 1/2 years (Exhibit 7). These two corporations were closely affiliated. Theodore H. Smyth was president of both, and his wife, Elizabeth M. Smyth, was vice-president and sole stockholder of both. The directors of both corporations were the Smyths and their attorneys (Record 137). The lease to Surf Associates, Inc., was part of a scheme to develop the land by building on it a cooperative apartment to be known as "Waikiki Manor" (Record 136-137).

On July 21, 1959, Surf Associates, Inc., not

having paid any rent under the lease, was in default, and appellee had the right to cancel the lease. Surf Associates, Inc., never paid any rent (Exhibit 7, Record 137).

On August 4, 1959, Surf Associates, Inc., contracted with Weed, Wallace & Associates, Inc., for plans and other architectural services for the projected building (Exhibits 8A, 8C; Record 138).

Sometime between August 4, 1959 and December 1, 1959, the Waikiki Manor project was abandoned. Construction was never begun (Exhibit 8C, Record 137).

On March 8, 1960, appellee gave appellant a sixty-day option to lease the same land for fifty-five (55) years (Exhibit 4). It is agreed that appellant knew that the abandoned Waikiki Manor project included a lease to Surf Associates, Inc., and that both corporations were controlled by the Smyths (Record 143-145). It was stipulated that appellee's witnesses would have testified that they told appellant before he signed the option that the old lease was still outstanding but could be cancelled (Record 145). Appellant's stipulated testimony contradicted them (Record 143). In any event, the option agreement made no mention of Surf Associates, Inc., or any lease but the one it promised appellant (Exhibit 4).

The option agreement recites that appellee "is the owner" of the lands described (Exhibit 4, p. 1) and offers a lease for "fifty-five (55) years from and after and retroactive to March 8, 1960, being the date of this instrument" (Exhibit 4, p. 2). It gives many details of the lease, including a minimum annual rent of $100,000, the requirement that appellant build a 400-room, $3,200,000 hotel and a provision that the lease "shall include generally the usual terms and conditions contained within a land lease covering business or hotel properties in Hawaii" (Exhibit 4, p. 10).

On March 28, 1960, Theodore H. Smyth informed appellant of "word just received of the threat of a law suit from our former architect over his fee" (Exhibit 1).

On or after April 26, 1960, Theodore H. Smyth sent appellant certain papers (Exhibit 5). These papers, if executed by appellant and substituted for the first and last pages of the option agreement, would have made Surf Associates, Inc., the optionor instead of appellee. Appellant did not execute them.

On May 9, 1960, the last day of the option (May 8 was a Sunday, Record 134), appellant wrote to appellee electing to cancel the lease and demanding the return of the $50,000 option money (Exhibit 1, Record

(136). He named the lease to Surf Associates and the architect's claim as his reasons.

On January 20, 1961,Weed, Wallace & Associates, Inc., filed a mechanics' lien in the Circuit Court of the First Circuit, State of Hawaii, against Surf Associates, Inc., Waikiki Manor, Ltd., appellee and Mr. and Mrs. Smyth in the amount of $64,661.63 unpaid architect's fees (Exhibit 8A).

On February 1, 1961, appellant filed this action against appellee for the return of the $50,000 option money and for $28,025.46 expenses made in reliance on the option (Record 2-11).

On February 9, 1961, the persons against whom the lien was filed brought suit in the First Circuit Court to have the lien vacated and cancelled. They admitted the existence of the contract between Surf Associates, Inc., and the architects, and made no claim that it had been paid (Exhibit 8A).

On April 30, 1963, the First Circuit Court vacated the lien. The reason stated was that, as the project had been abandoned before any permanent physical work was done, there had been no improvement of the property, and the architect's claim was outside the purview of the

mechanics' lien statute (Exhibit 8D).

On May 9, 1963, the pretrial order herein was filed (Record 133-149) and shortly thereafter the case was submitted to the Court below on the facts and testimony as stated therein.

On December 11, 1963, judgment for the appellee was entered (Record 206-207); and

On January 7, 1964, the judgment was amended to include attorney's fees (Record 225).

On May 10, 1965, this Court remanded without passing on the merits, because the issue of the lack of diversity raised by defendant, appellee had not been satisfactorily determined (345 F. 2d 173 [1965]).

On October 17, 1967, the Court below entered judgment for appellee, reiterating and reaffirming its original decision (Record 256-257), after finding that appellee's principal office was located in Santa Barbara, California (Record 254).

QUESTIONS PRESENTED

1. Does an option to give a lease "which shall include generally the usual terms and conditions contained within a land lease covering business or hotel properties

in Hawaii" imply that a covenant of title will be included in the lease?

2. Can such an implied covenant be contradicted by parol evidence?

3. Does an option offering a lease "from and after and retroactive to" a certain date covenant that the optionor can give such a lease on that date?

4. Is an optionor in default if it is impossible for him to comply with the terms of his option even though the option is not exercised?

SPECIFICATIONS OF ERROR

The Court below erred in giving judgment for appellee because:

1. The Court below erred in holding that no covenant of title was implied in the option agreement.

2. The Court below erred in allowing parol evidence to vary the covenant of title implied in the lease as a matter of law.

3. The Court below erred in holding that appellant had to exercise his option in order to show that appellee was in default.

SUMMARY OF ARGUMENT

The errors made by the Court below sprang from the failure to recognize the significance of the unusual fact that the lease was to be "from and after and retroactive to March 8, 1960," the date of the option agreement.

In the option agreement, appellee promised to give a lease including "the usual terms and conditions," effective the date of the option agreement. Since a covenant of title is implied (unless it is expressed) in the usual lease, it was impossible for appellee to keep the promise of its option agreement unless it could give such a covenant on March 8, 1960.

An optionee is entitled to the return of his option money if the optionor is unable to comply with the terms of the option. The optionor in this case bargained away any reasonable time to make good his title by covenanting that he could give good title as of the first day of the option, rent to be retroactive to and paid from that date.

The Court below found that appellant "was fully aware of the situation, including the outstanding lease to Surf Associates, Inc.," before the signing of the option (Record 203) and that because of this knowledge, appellee

could have complied with the option agreement by cancelling the lease to Surf Associates, Inc. This decision was erroneous because it allows an understanding implied from parol evidence to vary the covenant of title implied by law in the written agreement. It is, moreover, erroneous because appellee never showed that the Smyths could transfer the lease from one corporate pocketbook to the other without perpetrating a fraud on the creditors of Surf Associates, Inc.

ARGUMENT

I. THE OPTION AGREEMENT PROMISES THAT APPELLEE CAN GIVE A GOOD COVENANT OF TITLE ON MARCH 8, 1960, THE DATE OF THE OPTION AGREEMENT.

The option is for a lease. The first thing the option agreement tells us about the offered lease is that it is to begin March 8, 1960:

> 4. Terms of Lease Subject to Option. In the event that Second Party shall exercise said option within the allotted sixty (60) day period, he shall be entitled to and obligated for a lease of such property on the following terms and conditions:
>
> (a) Term of Lease: Said lease shall be for the term of fifty-five (55) years from and after and retroactive to March 8, 1960, being the date of this instrument. (Exhibit 4, p. 2)

It is thus explicit that at whatever time during

the option period the appellant might exercise his option, the terms of the lease would refer back to the date the option agreement was made. This is confirmed by the provision that the rent will begin March 8, 1960, the $50,000 option money to be the first six months' rent (Exhibit 4, para. 4(b)(1), pp. 2-3).

The option agreement also expressly provided that the lease would "include generally the usual terms and conditions contained within a land lease covering business or hotel properties in Hawaii, including clauses relating to maintenance of insurance, maintenance and replacement of buildings, restrictions on assignability and similar typical lease clauses" (Exhibit 4, p. 10).

It is thus clear and explicit that the lease offered was to contain the "usual terms and conditions" effective March 8, 1960. The only vagueness was as to what these "usual terms and conditions" are. There can, however, be no doubt that they would contain a covenant of title. Covenants of title are implied in a lease by Hawaiian law.

Lee Hoy v. Kapiolani Estate, 26 Hawaii 489 (1922) quoting Rawle's Covenants, Sections 272, 273:

With respect to estates less than free-

> hold, covenants for title were from the earliest times implied not only from the words of leasing, such as 'demisi,' 'concessi,' or the like, but even from the relation of landlord and tenant, and such is the law at the present day, unless where, as in some of the United States, it has been altered by legislation.
>
> The covenants for title thus implied from the words of leasing were and are two -- first, a covenant that the lessor has the power to demise, and secondly, a covenant for quiet enjoyment.

See also: Stott v. Rutherford, 92 U.S. 107, 109 (1875);

1 Tiffany, Landlord and Tenant, Section 80 (1910 Ed.);

1 American Law of Property, Section 3.46;

51 C.J.S., Landlord and Tenant, Section 239.

The covenant of good title and right to lease is broken when given, and no eviction is required.

1 American Law of Property, Section 3.46;

51 C.J.S., Landlord and Tenant, Section 239.

Thus it was held in McAlester v. Landers, 70 Cal. 79, 11 P. 505 (1886), where a portion of the property leased was already leased to another, that the lessor broke his

covenant of title as soon as he made it.

The lease would, of course, have been signed and delivered only after the exercise of the option. But the agreement provided that it would be retroactive to March 8, 1960, and the appellee would receive rent from that date. There is no way in which a lease containing the usual terms could be effective as of March 8, 1960, unless appellee could give a covenant of title as of that date.

II. APPELLEE WAS IN DEFAULT EVEN THOUGH APPELLANT HAD NOT EXERCISED THE OPTION.

The Court below held as follows (Record 201, Court's footnotes, emphasis added):

> A person may contract to sell land which he does not own. <u>There is no implied covenant that he has a clear, or any, title at the time the contract is entered into. His only obligation is to be able to convey a clear title at the time agreed upon for a conveyance</u>. 2/ There is no difference in this respect between an agreement to convey title and an agreement to give a lease. It necessarily follows that, unless plaintiff exercised the option and defendant was unable at that time to execute a valid and clear lease, defendant would not be in default under the option agreement. As has been pointed out, plaintiff did not exercise the option.

2/ JOYCE v SHAFER (1893), 97 Cal. 335, 32 P. 320 See also, LUETTE v. BANK OF

ITALY NAT. TRUST & SAVINGS ASS'N. (1930), 9th Cir., 42 F. 2nd 10.

The proposition that "a person may contract to sell land which he does not own" is undoubtedly true. In this case, however, there was a clearly expressed covenant that appellee could give a lease beginning the very day the option was executed. In such a case the optionee is entitled to rescission and the return of his option money without exercising the option. The reason for this distinction is succinctly stated at 55 Am. Jur., Vendor and Purchaser, Section 44:

> The consideration for the money paid for an option is the right to call for a conveyance during the time limited, and ordinarily, if the option is not exercised during the time, no claim arises against the vendor for the money paid; but if the option requires the conveyance of good title, and the title is defective the purchaser may rescind and recover back the consideration paid. And where he is entitled to call on the vendor for the conveyance of a good title at any time during the life of the option, the vendor must be in a position at all times to comply with such a request, and if the purchaser, within the time named in the option, ascertains that the vendor has no title and therefore cannot make a good conveyance of the land named, he may at once rescind the option and recover what he has paid thereunder, without first tendering payment and demanding a conveyance, and it is immaterial that the vendor after notice of the rescission offers and is in a position to make a good title.

The cases cited by the Court below deal with installment sales in which the conveyance was to be made only after all installments were paid. They are part of a line of California cases, some of which deal with options and support the distinction made in the passage from American Jurisprudence quoted above.

In Seeburg v. El Royale Corp., 54 Cal. App. 2d 1, 128 P. 2d 363 (1942), rescission without prior exercise of the option was denied expressly because, "Here the plaintiff's option allowed the defendant thirty days after acceptance to comply with the terms of the option; . . ." by which fact the Court distinguished the case from Burks v. Davies, 85 Cal. 110, 24 P. 613 (1890), and Backman v. Park, 157 Cal. 607, 108 P. 686 (1910).

In Burks v. Davies, the optionee had a 23-day option to purchase land. He discovered that the optionor did not have title to part of the land involved and sent the optionor a notice of rescission which arrived, like the one in the case at bar, on the last day of the option. The optionor immediately offered to clear up the defect and did in fact obtain an offer of sale from the true owner the next day. The California Supreme Court required the return of the option money, quoting Goetz v. Walters, 34 Minn. 241, 25 N.W. 404 (1885):

> He (the optionor) was bound to be prepared at all times within the thirty days to convey a good title, and, whenever within that time she (the optionee) should ascertain that he had no title, so that it was impossible for him to make a conveyance, she could at once avoid the contract without going to the useless trouble of tendering payment and calling on him to convey.

In Backman v. Park, 157 Cal. 607, 108 P. 686 (1910), the California Supreme Court reconciled Burks v. Davies with Joyce v. Shafer [cited in the decision below as holding that a person may sell what he does not own, (Record 201)], pointing out that where an option can be exercised at any time, the optionor must always be ready to perform and must, therefore, always have good title.

See also: Tatum v. Levi, 117 Cal. App. 83, 3 P. 2d 963 (1931).

The Court below erred in attempting to apply one hard and fast rule to all options, whereas there are a significant variety. For instance, Doe may give Roe an option to purchase Blackacre, the conveyance to be made thirty days after Roe exercises the option by paying Doe half the purchase price of $50,000. Doe has bargained for the time and the money with which to perfect his title to Blackacre. In such a case he is obviously not in default until he has had the time and money he

bargained for. On the other hand, Doe might give Roe an option to buy Whiteacre with the covenant that Doe already had clear title. In such a case, Roe has bargained and paid for the assurance that he is buying a "bird in the hand."

In this case, appellant paid $50,000 for a "bird in the hand," the promise that appellee could give a lease effective the first day of the option period. If that promise was untrue, appellant did not get what he paid for. In this case, there was a great difference between the "bird in the hand" and the "bird in the bush." Any cloud on the title could, and probably did, jeopardize appellant's attempts to finance the $3,200,000 hotel which the proposed lease required him to build (Exhibit 4, p. 9).

Moreover, exercising the option would have not only incurred an obligation to spend $3,200,000 improving property of dubious title, it would also have prevented appellant from questioning appellee's title. It is generally recognized that exercise of an option works an equitable conversion. 91 C.J.S., Vendor and Purchaser, Section 13, p. 865; 43 Am. Jur., Vendor and Purchaser, Section 43. For this reason, and because the term of the

lease and the obligation for rent were to be retroactive to March 8, 1960 (Exhibit 4,pp. 2-3), there was a serious risk that exercise of the option would be held to have automatically created the relationship of landlord and tenant. It is established Hawaii law that a lessee is estopped to assert a defect in his landlord's title.

Keelikolani v. Robinson,
2 Hawaii 436 (1861);

Peterson v. Frazier,
18 Hawaii 457 (1907);

Kaui v. See Kang,
20 Hawaii 690 (1911).

Ordinarily a tenant is protected from the harshness of this rule because eviction will terminate his obligation for rent, but this would be cold comfort to appellant if it happened after he built the $3,200,000 hotel. The implied covenant of title was no trifling technicality; it was essential that appellee have a clear title before appellant incurred the onerous obligations laid on him by the lease by exercising the option.

III. THE IMPLIED COVENANT OF TITLE COULD NOT BE VARIED BY PAROL EVIDENCE.

The question of the use of parol evidence was raised by appellant (Record 202) and preserved in the pre-trial order (Record 148).

Testimony was not taken at trial, but was stipulated to in the pre-trial order, the pertinent parts of which are at pages 143-146 of the record. Theodore H. Smyth's testimony was stipulated as follows (Emphasis has been added, Record 145):

> Mr. Smyth would testify that on March 7, 1960 and March 8, 1960 in the law offices of Lewis, Buck and Saunders, Honolulu, Mr. Smyth attended negotiations between Mr. Saunders and Mr. Barkhorn wherein Mr. Smyth heard Mr. Saunders tell Mr. Barkhorn prior to the signing of the option agreement that Adlib Associates, Inc. had granted a lease to Surf Associates, Inc. but that that lease was in default; that Surf Associates had some substantial losses which should be recouped if possible; that neither Mr. Saunders nor Mr. Smyth were certain which corporation should be the optionor; that since Adlib Associates, Inc. owned the fee, it should be the optionor but that it was expressly understood that the right to substitute Surf Associates, Inc. as optionor was agreed; that Adlib Associates, Inc. also had the ability to cancel the lease because Mr. and Mrs. Smyth were president and vice-president respectively of both Adlib Associates, Inc. and Surf Associates, Inc., and that Mr. and Mrs. Smyth and their attorneys comprised the board of directors of both corporations and that Mrs. Smyth was the sole stockholder of both corporations.

> Mr. Barkhorn replied that he was not concerned as to whether Adlib Associates, Inc. or Surf Associates, Inc. gave him an option just as long as he got the property.

Mr. Saunders' testimony as stipulated was substantially the same (Record 144-145). Appellant Barkhorn's (Record 143-144) is also similar except that:

> . . . Mr. Barkhorn does not recall any statement that the Surf Associates lease was outstanding or that Surf Associates could be substituted as optionor (Record 143)

The parties then signed the written agreement (Exhibit 4) in which every act normally associated with a lessor is associated with appellee, in which appellee is called the Lessor (Exhibit 4, p. 2), and in which there is no mention anywhere in its eleven pages of the existence of any outstanding lease, the substitution of another party as optionor, or any reference whatsoever by name or description to Surf Associates, Inc.

Even if there were some sort of a provisional understanding between the parties, appellant and appellee abandoned it when they left it out of their written agreement. The parol evidence rule prevents the use of these prior conversations to vary the express

terms of the written agreement, for instance by reading into it the agreement that Surf Associates, Inc., could be substituted as optionor. The parol evidence rule also forbids their use to vary the covenants implied in the written agreement by force of law.

Bishop Estate Trustees v. Castle & Cooke, 45 Hawaii 409, 368 P. 2d 887 (1962):

> The extrinsic evidence of the surrounding facts and circumstances existing prior to, contemporaneously with and subsequent to the execution of the deed, as alleged, in the amended complaint, is not competent to contradict, defeat, modify or otherwise vary the meaning or legal effect of the deed. (Emphasis added, citations omitted) The parol evidence rule, being a rule of substantive law, precludes the consideration of this extrinsic evidence . . . . (45 Hawaii 422, 368 P. 2d 894)

32 C.J.S., Evidence, Section 852:

> The legal effect of a written instrument, even though not apparent from the terms of the instrument itself, but left to be implied by law, can no more be contradicted, defeated, modified, varied, explained, or controlled by parol or extrinsic evidence than if such effect had been expressed.

See also: 2 Jones, Evidence, 5th Ed., Section 466, n. 3.

A case in point in the present situation is LaFrance v. Kashishian, 204 Cal. 643, 269 P. 655 (1928), where a suit was brought for breach of an implied warranty of title and quiet enjoyment and the Court held that parol evidence showing a different understanding as to title at the time of entering the contract could not be introduced under the parol evidence rule for the reason that it varied the legal effect of the contract.

The objection was raised by appellant (Record 148) and rejected by the Court below (Record 202):

> Plaintiff objects to evidence as to information given him orally by persons acting in behalf of defendant, on the ground that it contradicts the claimed "implied warranty of title." The Court has ruled that there was no "implied warranty of title" during the existence of the option agreement. Therefore, such testimony, if material, would not be excluded by the parol evidence rule.

Once again the error stems from misreading the option agreement so as to leave out the fact that it promises a covenant of title effective March 8, 1960.

IV. THE ENCUMBRANCES ON THE PROPERTY CONSTITUTED A BREACH OF COVENANT.

1. The option agreement said that the lease would be "from and after and retroactive to March 8, 1960." The covenant of title would be that appellee had sufficient title to give a lease on that day. Unless appellee had title on March 8, 1960, it could not give a lease effective that day. As has been pointed out above, the assurance that the bird already was in the hand was a valuable consideration for which appellant had bargained and paid. Appellee's ability to subsequently clear the deficiencies in its title is not even the substantial equivalent of what it promised.

2. The Court below erred in assuming that because the State Court vacated the architect's lien, that there had, therefore, been no cloud on appellee's title. It is generally recognized that the likelihood of litigation involving a substantial question of fact or law is a cloud on title: "Thus a title may be such that a titleholder would prevail in an action of ejectment or in a suit to quiet title, and yet the title may be an unmarket-

able one." 92 C.J.S., Vendor and Purchaser, Section 191 (c).

See also: 92 C.J.S., Vendor and Purchaser, Sections 191, 196;

3 American Law of Property, Section 11. 48;

55 Am. Jur., Vendor and Purchaser, Sections 174, 175.

The work done by the architects included making:

> . . . plans for a small building, called a mock-up, which was a model or replica of an apartment as the apartments were expected to appear in the apartment building. The mock-up was not affixed to the land, and was to be removed when it ceased to be used for advertising purposes or when the construction of the building was commenced. The mock-up was completed and the last work thereon was performed on November 11, 1959 . . . . (Exhibit 8C)

The Hawaii mechanics' lien statute provides:

> Any person or association of persons furnishing labor or material in the improvement of real property shall have a lien upon the improvement as well as upon the interest of the owner of such improvement in the real property upon which the same is situated, or for the benefit of which the same was constructed, for the price agreed to be paid (if the price does not exceed the value of the labor and materials), or if the price exceeds the

value thereof or if no price is agreed upon by the contracting parties, for the fair and reasonable value of all labor and materials covered by their contract, express or implied.

Where the terms of a lease, contract of sale or instrument creating a life tenancy require the improvement of the real property, the interest of the lessor, vendor or remainderman in the improvement and the land upon which the same is situated shall likewise be subject to the lien, and any provision for forfeiture or other penalty against the lessee, vendee or life tenant in case of the filing of a mechanic's or materialman's lien or actions to enforce the same, shall not affect the rights of such lienors. (R.L.H. 1955, Section 193-41)

Section 193-40 includes several definitions:

"Improvement" includes the construction, repair, alteration of or addition to any building, structure, road, utility, railroad or other undertaking or appurtenances thereto, and includes any building, construction, erection, demolition, excavation, grading, paving, filling in, landscaping, seeding, sodding, and planting, or any part thereof existing, built, erected, placed, make or done on real property, or removed therefrom, for its benefit.

"Labor" includes professional services rendered in furnishing the plans for or in the supervision of such improvement.

The decision of the State Court vacating the lien was apparently based on appellee's argument that the model apartment was not a permanent improvement of the

land. This decision could not be safely predicted. Any improvement is more or less temporary, and the statute includes such evanescent improvements as "seeding, sodding and planting." Nor does it require that the improvement be "affixed" but instead says "situated." It is clear from Theodore H. Smyth's letter to appellant on March 28, 1960 (Exhibit 2), that the model remained on the land long after the Waikiki Manor project was abandoned, and that Smyth thought it would be of value in appellant's sales. In fact, he offered to sell it to appellant for nearly $8,000. Had this evidence been made available to the State Court, its decision would probably have been different from the one it made. (Exhibit 8D shows that the lienor presented neither evidence of facts nor arguments of law to the State Court.)

There is genuine doubt as to the meaning of the Hawaii mechanics' lien statute. Another judge of the same First Circuit Court determined that an architect did have a lien arising from another abandoned apartment house project of which the only thing actually erected was a sign advertising the project erected on the site, for which sign the architect had made a sketch.

Wagner v. Martin, First Circuit Court, State of Hawaii, Civil No. 8606, decision of Dyer, J., March 27, 1962. The decision, with a statement of the facts extracted from the record, is set forth in the appendix to this brief.

3. The Court below held that the fact that Surf Associates, Inc., had never paid any rent gave appellee the right to cancel the lease, which cancellation would satisfy the option agreement (Record 200-201). Aside from the fact that the cancellation would not enable appellee to perform its promise to give a lease effective March 8, 1960, it was never proven that such a cancellation could not be set aside as a fraud on creditors. The evidence strongly suggests that it could have been set aside. To summarize:

(a) Appellee and Surf Associates, Inc., were both the sole property of Elizabeth M. Smyth, and under the complete control of her and her husband (Record 137).

(b) That Surf Associates, Inc., never paid the rent due under the lease, which consequently was in default from and after July 21, 1959 (Record 137, Exhibit 7).

(c) That after the default, Surf Associates, Inc., contracted with the architects (Record 137). In the lien suit, Surf Associates, Inc., and appellee admitted the existence of this contract and made no claim that the payments made by Surf Associates were full payment thereof (Exhibit 8A, 8C).

(d) That, in Theodore H. Smyth's words, "Surf Associates had some substantial losses which should be recouped if possible" (Record 145).

(e) That the architects were prepared to litigate their claim and appellee knew it (Exhibit 2). When the architects brought suit, they did not sue Surf Associates, Inc., in contract, but sought a remedy against the other persons involved.

With the exception of the last paragraph, (e), these facts were the extent of appellant's knowledge at the end of the option period. It was not clear whether Surf Associates, Inc., was not paying its rent and architects' fees from choice or necessity or a mixture of both, but it was clear that it was not paying its debts as they came due.

To some courts the inability to pay debts as they come due by definition is insolvency.

Wilkinson v. Livingston,
45 F. 2d 465 (8th Cir. 1930);

Cohen v. Sutherland,
257 F. 2d 737 (2d Cir. 1958);

29 Am. Jur., Insolvency,
Section 2, n. 14.

Whether this is the Hawaii definition of insolvency is not decided. It is decided that the transfer of property while "the transferor is indebted or insolvent" is one of the "badges of fraud" listed in Achiles v. Cajigal, 39 Hawaii 493, 497 (1952). Another one, that "the conveyance is made while a suit against the debtor is pending or threatening" was clearly present in this case, and a transfer from one family corporation to another owned and controlled by the same people is either covered by or analogous to a third, "The conveyance is made to a family member or to one of close relationship." The Hawaii Supreme Court said of this list of badges of fraud that:

> None of these alone proves fraud but warrants an inference of fraud, particularly where there is a concurrence of many badges. (39 Hawaii 497)

Surf Associates, Inc., was admittedly in debt, and although the conveyance was formally a cancellation

for default, the testimony of the Smyths and their lawyer had been insistent on the fact that it was really a voluntary conveyance which the Smyths might or might not make as it suited them from one corporate pocketbook to the other. In such a situation, the burden was on appellee to prove that the conveyance would not be fraudulent.

Ga Nun v. Palmer, 216 N.Y. 611, 111 N.E. 223 (1916):

> The rule is that a transfer without consideration by one who is then a debtor raises a presumption of fraud. The creditor may stand upon that presumption until it is repelled. It is not for him to show what other property was retained. (Cardozo, J.)

Feist v. Druckerman, 70 F. 2d 333 (2d Cir. 1934):

> It imposes on the volunteer transferee of one who has creditors the duty of going forward with proof to show the solvency of the transferor in order to prevent the conveyance from being set aside. The presumption has existed in many of our states, and we see no reason to suppose that the uniform acts proposed to destroy such a rule of procedure . . . . (A. N. Hand, J.)

Kemp v. Metropolitan Life Ins. Co., 205 F. 2d 857, 864 (5th Cir. 1953);

Hartman v. Lauchli,
238 F. 2d 881, 888 (8th Cir. 1956),
cert. denied, 353 U.S. 965;

Westminster Sav. Bank v. Sauble,
183 Md. 628, 39 A. 2d 862 (1944);

37 C.J.S., Fraudulent Conveyances,
Section 100, n. 86.

This rule applies only to voluntary conveyances, which normally means only those for which there is no consideration. If Surf Associates, Inc., were a stranger to appellee and the Smyths, the cancellation of the lease would not be a voluntary conveyance, but in such a situation, appellee could not claim that it was certain of promptly clearing its title. Appellee's argument, as its evidence so strongly emphasizes, is that the cancellation would be voluntary on both sides because the Smyths controlled Surf Associates, Inc., which would surrender possession, and would not litigate appellee's right to cancellation.

Appellant, at the time that he had to decide whether to rescind or go ahead with the option, was faced with at least a probability that any measures taken by appellee to correct the defects in its title could be set aside as in fraud of creditors. The cancellation of

the lease carried at least two, and perhaps three of the badges of fraud listed in Achiles v. Cajigal, 39 Hawaii 493, 497, and as the Court said in that case, each of them "warrants an inference of fraud."

CONCLUSION

For the foregoing reasons it is respectfully submitted that the judgment below should be reversed.

DATED: Honolulu, Hawaii, April 3, 1968.

Respectfully submitted,

BURNHAM H. GREELEY

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BURNHAM H. GREELEY
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Of Counsel

APPENDIX

1. Exhibits. All exhibits were identified and received in evidence as part of the pre-trial order (Record 147):

1 Letter, dated May 9, 1960, from Barkhorn Associates (Charles J. Barkhorn, Jr.) to Adlib Associates, Inc. re Option Agreement of March 8, 1960.

2 Letter dated March 28, 1960, from Theodore H. Smyth to John Barkhorn.

3 Letter dated March 8, 1960, from John Barkhorn to Theodore H. Smyth and Mrs. Elizabeth M. Smyth.

4 Copy of Agreement dated March 8, 1960 by and between Adlib Associates, Inc., and Charles John Barkhorn, Jr., (the Option Agreement).

5 The proposed substitute first page and page 11 of the Option Agreement (Exhibit 4), executed by Surf Associates, Inc., only.

6 Copy of Land Court Document No. 244549, referred to in paragraph 6 of the Option Agreement (Exhibit 4).

7 Copy of Indenture of Lease, made July 1, 1959, by and between Adlib Associates, Inc., and Surf Associates, Inc.

8 Copies of the following papers filed in Civil No. 7370, Adlib Associates, Inc., et al, plaintiffs, vs. Weed, Wallace & Associates, Inc., defendant, First Circuit Court, State of Hawaii:

8-A Complaint and Exhibit 1 (being M.L. No. 1298, Circuit Court, First Judicial Circuit, Hawaii).

8-B Answer

2. Unreported decision in Wagner v. Martin, Circuit Court of the First Circuit, State of Hawaii, Civil No. 8606, Dyer, Jr., March 27, 1962. The following is the complete text of the decision, together with affidavit of the lienor setting forth the facts upon which the case was apparently decided:

CIVIL NO. 8606

IN THE CIRCUIT COURT OF THE FIRST CIRCUIT

STATE OF HAWAII

CHARLES F. WAGNER,

Plaintiff,

vs.

WATTERS O. MARTIN, DOLORES M. MARTIN, RUTH QUAY SMITH, and MAHIOLE ENTERPRISES, LTD.,

Defendants,

and

FIRST NATIONAL BANK OF HAWAII, et al.,

Garnishees.

DECISION

From the Plaintiff's Supplemental Affidavit filed November 13, 1961, it appears to the Court that

when the evidence is in, Plaintiff may have at least a lien for the fair value of the water color that went into the sign.

I do not agree with the view that the structure must benefit the property in order for labor to be lienable, in view of the first part of the definition of "improvement" in Sec. 193-40 which makes no reference to benefit, and in view of the alternative language used in Sec. 193-41 giving a lien "upon the interest of the owner of such improvement in the real property upon which the same is situated, or for the benefit of which the same was constructed,-----" (Underscoring added).

There is no need at this time to determine whether the lien, if any, could embrace all of the professional services rendered by the Plaintiff.

The notice for summary judgment is denied.

Dated at Honolulu, Hawaii, this 20th day of March, 1962.

(SEAL)

/s/John F. Dyer
JUDGE OF THE ABOVE ENTITLED COURT

SUPPLEMENTAL AFFIDAVIT

STATE OF HAWAII)
CITY AND COUNTY) ss.
OF HONOLULU)

CHARLES F. WAGNER, being duly sworn, on oath deposes and says:

He is the plaintiff in the above entitled action and a resident of Honolulu, Hawaii;

He is a duly registered architect hired by defendants WATTERS O. MARTIN and DOLORES M. MARTIN to perform architectural services in connection with certain improvements to be placed on the real property situate on the corner of Kuhio Street and Kaiulani Avenue, Honolulu, Hawaii, all as more particularly described in the complaint filed in said action;

Architectural plans and specifications and other services in connection with and in furtherance of said employment were fully furnished and provided insofar as affiant was so permitted by the said defendants who refused to proceed with their agreement to complete the building;

A part of said plans and specifications were furnished and used in the improvement of the real

property aforesaid;

The plans and specifications so furnished to WATTERS O. MARTIN and DOLORES M. MARTIN included a watercolor painting embodying the studies, drawings, plans and other work affiant had done and made;

It is customary for an architect performing architectural services for an apartment building to furnish such a watercolor painting as part of the required plans and specifications;

Said watercolor painting was specifically requested by said WATTERS O. MARTIN so he could use it to guide a sign painter in preparing a sign to be erected upon the said premises;

Said watercolor painting was enlarged and copied by a sign painter upon a sign approximately twelve feet high and five feet wide to illustrate The Chief, a building to contain "150 spacious one-bedroom apartments," and among other things naming the following:

ESCROW AGENT	BANK OF HAWAII
ARCHITECT	CHARLES F. WAGNER
GENERAL CONTRACTOR	PACIFIC CONSTRUCTION COMPANY
DEVELOPERS	MAHIOLE ENTERPRISES, LTD. WATTERS O. MARTIN, PRESIDENT
INTERIOR DECORATORS	C. S. WO & SONS

Said sign further announced that the project was bonded and that the Sales Office was located at 1837 Kalakaua Avenue.

The aforesaid improvement included excavation of the land to provide post holes, and the building, erection and placing on said premises for the benefit thereof of a construction, erection and structure, to wit, the aforesaid sign, incorporating the professional work product of affiant as aforesaid;

The said real property is very valuable, being located in a hotel and apartment house zone, and contains three or more old and dilapidated wooden structures.

The facts stated herein are known to affiant through his personal observation and are based on inspections of the property, including observation both prior to and since the commencement of this suit.

* * *